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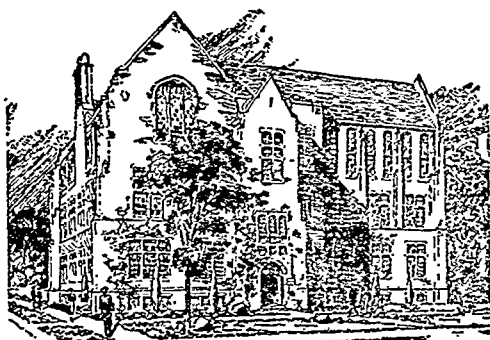
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TERMINATION OF WAR CONTRACTS

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ONE of the most serious problems which will confront postwar America is the impact on industry and labor alike of the termination of war contracts for the convenience of the Government. The magnitude of this problem can be pictured from the statement of General A. J. Browning, Director of the Purchases Division, A.S.F., made September 28, 1943, that the War Department alone then probably had more than 100,000 important prime contracts and at least 1,000,000 relatively important subcontracts, and that these are practical figures to use in considering the termination job at the end of the war. To these figures should be added the outstanding contracts of the Navy Department, Maritime Commission, Defense Corporation, and all of the other government agencies engaged, in whole or in part, in the procurement of materials useful in the prosecution of the war.

The aggregate dollar value of these contracts has been variously estimated from 50 billions to 75 billions of dollars.

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The War Department, as of August 31, 1943, had already completely or partially canceled 8,520 contracts of the aggregate face value of \$5,000,000,000. This is nearly \$2,000,000,000 more than the total face amount of the 27,000 terminated contracts in the first world war. Of these 8,520 canceled contracts, the War Department had finally settled 6,191, or more than 70%, by August 31, 1943. This must be reckoned as a major accomplishment, in view of the difficulties involved in these termination settlements. The settlement of each terminated contract involves the settlement of all subcontracts and purchase orders based thereon. The first step is getting the settlement proposal from the prime contractor and General Browning stated that an analysis of the August settlements, where the amount involved was over \$10,000, showed that the contractor took an average of 4.2 months to submit his proposal for settlements. The second problem is the disposition of materials. The present effort is to dispose of these materials rather than having the Government take title, and such disposal, of course, takes considerable time. The third problem is clearing subcontractors' settlement proposals. This will probably remain the most serious factor in the settlement of terminated contracts. General Browning has estimated that each of the three or four hundred major prime contractors of the War Department may have an average of 2,000 or more customers and 6,000 subcontractors.

TERMINATION CLAUSES IN WAR CONTRACTS

Most war contracts contain clauses permitting their termination at the convenience of the Government, and provide for the basis of settlement on termination. These provisions for settlement vary substantially in the contracts of the Army, the Navy, the Maritime Commission, the Defense Plant Corporation, and other war agencies, and in the cases of the same war agency, as experience has from time to time indicated such changes.

In general, these termination clauses provide for payment in full to the prime contractor of all materials completed in accordance with the contract before the termination becomes effective; for proportionate payment for partly finished materials, with some measure of profit on the partly finished work; the taking over by the Government or sale of all of such partly finished products and all raw materials, drawings, patterns, etc. used in connection with the performance of such contract; and the reimbursement of the prime contractor for all sums paid to subcontractors and sub-subcontractors in settlement of their respective claims, provided such settlements have first been approved in writing by the Contracting Officer.

The Procurement Policy Committee of the War Production Board and the various war agencies for over a year, worked on a uniform termination clause for use by all of the war agencies.

The War Department, which has, by far, the largest number of outstanding contracts, has issued its Procurement Regulation No. 15¹ governing the termination of contracts for the convenience of the Government, which regulation consists of approximately 75 pages, single space, and has also issued a Technical Termination Accounting Manual for fixed price supply contracts, consisting of upwards of 40 pages, single space. This is further evidence of the complicated nature of termination procedure.

On January 8, 1944, the Director of War Mobilization, Justice Byrnes, issued a directive to all procurement agencies making immediately effective a Uniform Article for the termination of government fixed-price war supply contracts, and a Statement of Principles to be followed by such departments in determining costs.

The directive was based upon a recommendation of Mr. Bernard Baruch and Mr. John Hancock, Chairman of the Joint Contract Termination Board composed of representatives of the various departments, which Board has agreed to the Article and the Statement of Principles.

The Uniform Termination Article and Statement of Principles covered by the directive of January 8th apply only to prime contracts. Subcontracts are still under consideration.

In general the Uniform Termination Article follows the past practice as above outlined, but there are several notable changes. One of these relates to the limitation of aggregate profits on uncompleted products to a maximum of 6%, and the profit on unprocessed inventory to a maximum of 2%, and this only to inventory properly allocable to the contract. Both of these rates of profit are maximums, and smaller percentages may be allowed in some instances. Finished materials will be paid for at the full contract price, as heretofore.

There is also express provision for partial payments and payments on account, and authority for an equitable revision of the contract price for work not terminated by the Notice of Termination.

The principle of "Negotiated Settlements" initiated by the War Department and described below, is expressly provided for in the Uniform Termination Article, and "Negotiated Settlements" are not subject to the profit limitations above set forth, but may include "a reasonable allowance for profit."

¹ Termination of Contracts for the Convenience of the Government. Procurement Regulation No. 15, August, 1943. War Department Headquarters, Army Service, Washington, D. C.

NEGOTIATED SETTLEMENTS

War Department Procurement. Regulation No. 15 contains provisions for so-called negotiated settlements, which are intended to eliminate much of the delay and many of the complications of fully audited settlements by both the war agency and the General Accounting Office, as otherwise provided by law. The purpose is to give the Contracting Officer authority to work out with the contractor a fair settlement of the amount due on the uncompleted portion of the contract and, while the procedure provides for such investigation of the facts and such spot checks as may be necessary to enable the Contracting Officer to determine what constitutes a fair settlement, no detailed audit is required, and if the Contracting Officer and the contractor reach an agreement, a supplemental agreement is entered into for the final termination of the contract. Except in unusual cases, no approval by the Director of the Purchases Division Headquarters Army Service Forces of any such settlement agreement is required.

Authority for such negotiated settlements is found in the provision of Sec. 201 of the First War Powers Act,² under which the President may authorize any department or agency of the Government exercising functions in connection with the prosecution of the war effort to enter into contracts and into amendments or modifications of contracts theretofore or thereafter made and to make advance, progress, and other payments thereon, without regard to the provisions of law relating to the making, performance, amendment, or modification of contracts, whenever he deems such action would facilitate the prosecution of the war. (The President has given such authority.) The final settlement agreement is deemed to constitute an amendment to the original contract made for adequate consideration. Since Regulation No. 15 was issued, the War Department has entered into agreements with prime contractors, whose contracts did not include provisions for negotiated settlements, amending such contracts to provide therefor.

POSITION OF COMPTROLLER GENERAL ON NEGOTIATED SETTLEMENTS

Last September the Honorable Lindsay C. Warren, Comptroller General of the United States, in a letter to Senator James E. Murray, attacked the practice of war agencies investing final authority in Contracting Officers to settle war claims, stating that this practice is in derogation of the authority and jurisdiction vested in the General Accounting Office by the Budget and Accounting Act of 1921,³ and stating it as his opinion that in the enactment of the First War Powers Act and other wartime legislation there was no intention by Congress

² 50 U.S.C.A. § 611.

³ 31 U.S.C.A. § 71.

to divest the General Accounting Office of its authority and jurisdiction. He quotes, in support of his position, the following clause from Sec. 1 of the First War Powers Act:

"No redistribution of functions shall provide for the transfer, consolidation or abolition of the whole or any part of the General Accounting Office or of all or any part of its functions."⁴

The pertinent clause of the Budget and Accounting Act of 1921, above mentioned, is as follows:

"All claims and demands whatever by the Government of the United States or against it, and all accounts whatever in which the Government of the United States is concerned, either as debtor or creditor, shall be settled and adjusted in the General Accounting Office."⁵

It appears likely that Congress will enact legislation either (a) definitely confirming the authority of the war agencies to make negotiated settlements, or (b) depriving the war agencies of that authority. Considering the hundreds of thousands of prime contracts and the many millions of subcontracts and sub-subcontracts (reaching, in some cases, to the fourth and fifth tier), many of such subcontracts being for very small amounts, it is to be hoped that Congress will lodge definite authority in either the various war agencies or in some other body or bodies to continue the general policy of negotiated settlements, without the requirement of a complete audit.

Under the existing practice of the General Accounting Office, a contractor's claim must first be examined by the administrative department or agency executing the contract involved, which then furnishes a complete report of all facts and data pertinent thereto to the General Accounting Office, together with a recommendation on the merits of the claim. The facts, as reported by the contractor and by the administrative office, are then examined and reviewed by the General Accounting Office *in the light of the contract provisions and the applicable laws*, and the amount, if any, found proper for allowance is certified for payment. It would seem apparent that this procedure cannot be followed in settling terminated war contracts.

SUBCONTRACTORS AND SUB-SUBCONTRACTORS

Serious as are the problems confronting prime contractors in the settlement of their terminated war contracts, the situation of subcontractors and sub-subcontractors gives rise to even more serious apprehension and so far their difficulties remain largely unsolved. There is grave doubt as to the authority of the war agencies to lay down definite

⁴ 50 U.S.C.A. § 601.

⁵ 31 U.S.C.A. § 71.

rules governing the settlement of subcontracts and sub-subcontracts because of the absence of any contractual relationship between the war agencies and subcontractors. Some prime contractors, in placing subcontracts, have reserved the right to terminate them when their prime contract is terminated by the Government and have set up formulae for the settlement of such subcontracts when terminated. Many prime contractors and most subcontractors have made no such provisions, and where subcontracts contain formulae for settlement on termination, these formulae vary widely. A prime contractor may make many subcontracts in connection with one prime contract. Every order for material and every contract for services in connection with the performance of a prime contract constitutes a commitment of the prime contractor which plays a part in the settlement of his prime contract, if terminated. Each one of these subcontractors may place one or more subcontracts in connection with the performance of his contract with the prime contractor, and these sub-subcontractors in turn may do the same.

In the settlement of a terminated prime contract, the claims of all subcontractors and sub-subcontractors must be adjusted. If such subcontracts or sub-subcontracts contain formulae governing their settlement on termination, the settlements must be in accord with such formulae or by mutual agreement between the contractors involved in each such subcontract. If any of them fail to agree on settlements, litigation may be necessary to determine the amount of the liability. It is apparent that the prime contractor has no easy job in tracing to the last tier the subcontracts and sub-subcontracts entering into the performance of the terminated prime contract, and then securing settlements of all such sub-subcontracts and subcontracts as between the subcontractors involved in each of them, the final aggregate amount of which settlements becomes part of the prime contractor's claim on termination.

No settlement by the prime contractor of the claim of a subcontractor is binding on the Government under present procedure, unless such settlement has received the prior written approval of the Contracting Officer, and this takes further time. It seems reasonable to assume that a prime contractor, for his own protection, will, in most cases, withhold payment of subcontractors' claims until such approval of the Contracting Officer has been obtained.

There is no present requirement that the settlement of claims of sub-subcontractors requires the prior approval of the Contracting Officer (largely, no doubt, because of the lack of contractual relationship between the Government and subcontractors), but until the prime contractor pays his subcontractors, the subcontractors, in many

instances at least, will be without funds to pay their sub-subcontractors. Many subcontractors and sub-subcontractors fall in the group designated as American "small business," with limited capital. Many other subcontractors not in the "small business" group have a large number of subcontracts and sub-subcontracts in the various tiers. One corporation known to the writer has, by reason of the nature of its business, been receiving, on the average, 16,000 subcontracts and sub-subcontracts per months, so that the aggregate amount involved in all of these subcontracts is so great that, unless some form of relief is provided, the procedure of tracing every sub-subcontract to its prime contract and delaying the settlement thereof until all such sub-subcontracts and subcontracts applying to a specified prime contract have been approved by the Contracting Officer would result in financial ruin to such subcontractors long before the required procedure had been completed.

Settlement of subcontracts is further complicated by the fact that some suppliers, by reason of the nature of their business, cannot delay ordering raw materials and parts which enter into the products they furnish until they receive a subcontract or sub-subcontract, but must buy "for inventory" in advance of such subcontracts. In case of termination of a prime contract to which such subcontract relates, they may have difficulty in establishing that such raw materials or purchase parts, or commitments therefor, relate to the particular canceled prime contract. If this happens in the case of any subcontractor in a large number of instances, due to the fact that he has many relatively small subcontracts, "termination" may leave him with an unwieldy inventory, largely exceeding his normal peace requirements, and with greatly impaired working capital.

PROPOSED REMEDIES

Bills are now pending in Congress to provide relief for contractors and subcontractors, many of whose working capital will be greatly impaired as the result of mass "terminations." One plan is to provide for mandatory initial payments by the Government of 75% of the amount claimed to be due to the contractor or subcontractor, with a proviso that if the amount so paid should eventually prove to be in excess of the amount due, the excess payment shall be deemed to be an interest-bearing loan. This proposal is opposed by the Comptroller General of the United States. Another plan is to make Government loans to prime and subcontractors pending settlement of their terminated contracts. This proposal is also opposed by the Comptroller General, unless the Government is assured, on the basis of the contractor's financial responsibility and his past record, that the loan would be repaid. A third proposal is to make modified V-loans to contractors and subcontractors based upon the entire contract and in-

ventory position of the contractor or subcontractor, these loans to be made by commercial banks and guaranteed, in part at least, by the Government. In view of the length of time it may take to settle the millions of terminated prime and subcontracts it is suggested that these loans be either made without interest or that the Government obligation bear interest to offset the interest on the loan. In the absence of contractual relationship between the Government and subcontractors, there may be practical difficulties in arranging for the payment of interest by the Government on subcontractors' claims.

It has also been suggested that the Government purchase the claims of subcontractors at some discount, either acquiring claims relating to individual prime contracts or by making a lump sum purchase of all of a sub or sub-contractors' claims and of the inventory relating thereto, thereby promptly restoring subcontractors' working capital and enabling them to promptly reconvert to peacetime production. This plan has a serious practical difficulty; subcontractors and sub-subcontractors may have terminated subcontracts with a large number of subcontractors or prime contractors with varying settlement agreements on termination; they may be indebted to their principal contractors either by way of advances on the terminated contract or arising out of other contracts with the same principal contractor; the Government, if it purchased for a lump sum all of the subcontractors' claims, would have to negotiate separately with each principal contractor involved for the settlement of those claims, the Government being only the assignee thereof and entitled to no greater rights against the principal contractor than the subcontractor whose claim it purchased.

All of the war services favor payments on account to prime and subcontractors of amounts admittedly due. In practice, however, this has thus far been rarely done in connection with contracts heretofore terminated because, under present law, a contracting officer is personally liable for any unauthorized payments made by him or by his authority. It seems clear that remedial legislation should be promptly enacted, at least in so far as the settlement of terminated war contracts is concerned, to relieve the Contracting Officer from this personal liability, when he acts in good faith.

It was suggested, as one means of expediting payments by prime to subcontracts and by subcontractors to sub-subcontractors, that a minimum formula for such settlements be fixed so that settlements can be safely made by prime and subcontractors, without securing the prior written approval of the Contracting Officer. Mr. Byrnes, in his directive, announced that serious administrative problems are involved in applying the principles of the Uniform Termination Article to subcon-

tractors, but that the matter is under consideration, and that the objective is to have the same principles of contract settlement apply to both prime and subcontractors.

If, and to the extent that any of the problems involved are based upon the absence of contractual relationship between the Government and sub and sub-subcontractors, it is suggested as a remedy a directive for the insertion in each prime contract of a provision binding each subcontractor to whatever formula is fixed for the settlement of sub-contractors and requiring each subcontractor to insert a similar provision in his sub-subcontracts, and so on down the entire tier of sub-subcontracts. It was further suggested, as a means of expediting settlements, that when a prime contract is terminated, the prime contractor be directed that, in giving notice of termination to its subcontractors, it identify the prime contract involved and that it request each subcontractor to do the same when notifying its sub-subcontractors of termination, so that each subcontractor and sub-subcontractor will know to which prime contract the termination of its subcontract relates and be enabled to allocate thereto the various items which would go to make up its claim against its immediate principal contractor.

On December 23, 1943, a subcommittee of the Senate Military Committee made a preliminary report setting forth certain general conclusions reached by it with respect to necessary legislation governing War Contract Terminations, and submitting an outline of a proposed bill, but withholding final decision thereon pending further study. This outline contains a number of provisions which appear very desirable. Among them are:

1. The existing authority of the contracting agencies to make "negotiated settlements" is recognized and clearly defined.
2. The financial liability of government officers for excess payments made in settlement of claims against terminated contracts is removed, except in cases of fraud.
3. The General Accounting Office may investigate all records and report suspected cases of fraud, but shall have no authority to withhold payment of funds.
4. Mandatory advance payments from 75% up to 100% of claims submitted by prime contractors are provided for; excess payments to be treated as loans.
5. Partial payments may be made to prime and subcontractors of amounts agreed upon as owing.
6. Direct loans may be made, or bank loans guaranteed by the contracting agencies.

7. Settlement of subcontractors' claims by the prime contractor, or with his consent by the Government agencies, or purchase of the claims if such consent is not obtainable, are authorized.
8. Contracting agencies are directed, whenever possible, to settle contracts on such a basis as to enable them to agree that the payments shall not be subject to renegotiation.
9. An "Office of Contract Settlement" is directed, the director to be appointed by the President, with the advice and consent of the Senate, to administer the Act.
10. The Smaller War Plants Corporation is given certain designated powers to aid small business concerns with their termination problems.